APPENDIX A

No. 19409

United States Court of Appeals
for the Sixth Circuit

Union Planters National Bank of Memphis, Plaintiff-Appellee, v. United States of America, Defendant-Appellant.	On Appeal from the United States District Court for the Western District of Tennessee, W. D.

Decided and Filed May 4, 1970.

Before: Celebrezze, McCree, and Combs, Circuit Judges.

McCree, Circuit Judge. This appeal presents the question whether coupon interest collected by a bank as owner of municipal bonds subject to repurchase agreements is exempt from taxation under § 103(a) of the Internal Revenue Code. We hold that under the circumstances of this case, it is not and accordingly we reverse the decision of the District Court, 295 F. Supp. 1151 (W. D. Tenn. 1968). Since 1938 or 1939, appellant Bank has purchased municipal bonds[1] from local bond dealers, subject to agreements permitting the Bank to require repurchase by the dealer at any time at the price paid by the Bank. The evidence does not disclose an instance when

[1] The term "municipal bonds" is used in this opinion to include those bonds and obligations issued by states, municipalities, and other local governmental units, which qualify for the exemption granted by § 103(a).

the Bank invoked this provision. Rather, as the District Judge found, "it was the intent and practice that the bonds be re-acquired by the dealer upon the dealer's request. . . ." 295 F. Supp. at 1152. The dealer usually repurchased the bonds when he had found a customer for them. The Bank invariably resold to the dealer at the same price it had paid him (this price was either the dealer's cost or a lower figure), and the dealer's repurchase at this price protected the Bank from experiencing any loss on the transaction.

During the period in which the Bank held the bonds, it would clip bond coupons as they matured and collect and retain the interest. On repurchase by a dealer, the Bank would be credited with the pro rata interest accruing from the last coupon redemption date until the date of repurchase. The tax treatment of coupon interest realized by the Bank in this manner in the years 1961-64 is the subject of this appeal.

The Bank claims that since it was the owner of the bonds and the coupons, the interest income from them should be exempt from taxation under § 103(a). The Government, on the other hand, insists that each transaction between the Bank and the dealers was in reality a loan secured by what was in effect a pledge of the bonds. Thus, the coupon interest belonged to the dealers and, when they permitted the Bank to keep it, they were paying the Bank what was in effect ordinary interest on the loan, which is income not exempt from taxation under § 103(a). Viewed in this context, the Government argues, the transactions constitute an attempt to avoid the effect of § 265(2) of the Internal Revenue Code. This provision disallows deductions of interest paid on loans the proceeds of which are used to buy municipal bonds. Its obvious purpose is to deny the recipient of tax exempt income the further tax benefit of deducting the cost of money

employed to purchase the securities which produce it. Accordingly, if the dealer had borrowed the money to purchase the bonds, the coupon interest would be tax-free to him, but he would not be able to deduct the interest paid to the Bank for the loan; and the Bank, of course, would be taxed fully on the income represented by that interest. But if the transactions are characterized as sales-repurchases, the Government contends, the Bank will avoid paying tax on the coupon interest, which in economic effect is equivalent to interest paid for the use of its money, and the dealer will have obtained the funds to purchase the bonds without paying interest. Thus, if the parties' characterization of these transactions is accepted as decisive for federal income tax purposes, they would be able to enjoy the benefit of the double tax advantage which Congress intended to prevent.

The form of these transactions tends to support the Bank's arguments. And the Government does not dispute the fact that the Bank held title to the bonds in a property law sense. Moreover, the Bank did not list these transactions on its books as "loans" except when required to do so by the Comptroller of the Currency from 1957 to 1964.[2]

However, other facts found by the District Court support the Government's position. The bond dealers would list these bonds for sale in trade publications in the same manner as bonds to which they held legal title. When a dealer found a customer for the bonds, he would repurchase them from the Bank which never refused to resell although, under the written repurchase agreements, it was

[2] Although not listed as loans during 1938-57 and 1964-70, nevertheless they were not carried on the Bank's books in the same category as bonds purchased for investment, which were of course not subject to the kind of repurchase agreements we are concerned with here.

not bound to do so. The District Judge found that it was understood between the parties that the Bank would always consent to such repurchases. More important, the Bank was protected under the repurchase agreements from suffering any loss, and its gain was limited to the amount of coupon interest accruing during the time it held the bonds.[3] In some cases, when the market price of the bonds was falling, the Bank required the dealer to pay, in advance of repurchase, money sufficient to protect it in the declining market. Obviously this practice served the same purpose as the requirement of the posting of additional margin by a borrower whose security is decreasing in value. It is clearly more consistent with the characterization of these transactions as loans than as sales.

The District Court, in ruling for the Bank, held that "[t]he determination of this case requires an inquiry into the intent of the parties." 295 F. Supp. at 1162. We do not agree that subjective intent is decisive here. The intent of the parties may be important in determining just what their contractual relations *inter se* were, but there is little dispute here about what obligations and rights the parties expected their agreement to confer. This case hinges, rather, on the legal characterization, for federal income tax purposes, of the transactions between the parties. That characterization is not a question of fact, but rather one of law. *Cf. Corbetta Const. Co. v. Dayton Rubber Co.*, 290 F. 2d 858 (6th Cir. 1961). Accordingly, we are not bound by the District Court's conclusion

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[3] On three occasions when the dealer refused to repurchase on demand by the Bank, the Bank sold the bonds to a third party and kept the resulting profit. The record does not disclose the details of these transactions, except that in one case the dealer was "probably insolvent". We would assume that all three dealers in question were insolvent or defunct; otherwise why would they refuse to repurchase when a profit was apparently guaranteed? In any event, these isolated incidents do not alter our opinion about the substance of the many dozens of these transactions.

that the Bank should be treated as the owner of the bonds for federal income tax purposes.[4]

We are not here concerned with an area of the law where intent determines whether or not an increment of wealth is to be deemed income, as was the case in *Commissioner v. Duberstein*, 363 U. S. 278 (1960), where the presence or absence of a subjective state of mind, donative intent, was declared to be decisive. Here the question is not whether or not an increment of wealth is income (for it clearly is), but whether it is income from interest paid by a borrower, or tax exempt interest income from municipal bonds.

In cases where the legal characterization of economic facts is decisive, the principle is well established that the tax consequences should be determined by the economic substance of the transaction, not the labels put on it for property law (or tax avoidance) purposes. *E. g., Commissioner v. P. G. Lake, Inc.*, 356 U. S. 260, 266-67 (1958); *Gregory v. Helvering*, 293 U. S. 465 (1935). "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering v. Lazarus & Co.*, 308 U. S. 252, 255 (1939).

Here it is clear that the coupon interest functioned as the interest collected on a loan, however the parties may have characterized the transactions on their books. Like any secured lender, the Bank took great pains to insure

[4] The intent which the District Court found binding was apparently the bank's intent to adopt the form of sale and repurchase, rather than that of a secured loan. It should come as no surprise that taxpayer wished to characterize the transactions in this way, because it results in minimum tax liability, and does not give any of the parties any economic rights which they would not have had if the transactions had been characterized as loans. If this kind of intent is to be decisive, then, as the Government argues, any taxpayer could "determine its own tax liability by choosing the names which its arrangement should be called when those labels will affect nothing but its tax liability." *Cf. Burnet v. Harmel*, 287 U. S. 103, 110 (1932).

itself against any loss of principal, even to the extent of requiring margin payments (which took the paper form of advances on the repurchasing price). And like any borrower on security, the dealer was obliged to pay only the amount of the principal in order to extinguish his obligation, besides having to forego the gains he would otherwise have made through the maturing of interest coupons. In contrast, in a transaction that would be characterized as a sale for tax purposes, we would expect the Bank, rather than the dealer, to assume the risk of fluctuations in the market value of the bonds.

The Fifth Circuit has recently ruled for the Government in a substantially identical case. *American National Bank of Austin v. United States*, No. 27301 (Jan. 19, 1970). We think that the Government's case here is, on balance, stronger than in the *Bank of Austin* case. Here, there were written repurchase agreements under which the Bank could oblige the dealer to repurchase at any time at a price which would guarantee the Bank against any loss; in *Austin*, the dealers had only an unwritten option to repurchase, and there was no written contract as there was here. Other differences between the operations of the Austin and Memphis banks[2] we deem immaterial.

We hold, for the reasons found persuasive by the Fifth Circuit in Judge Ainsworth's opinion, that these transactions, although characterized as sales-repurchases by the parties, will be regarded as secured loans for federal income tax purposes, and that accordingly, the Bank, as economic lender, cannot exclude the bond interest from its taxable income. The judgment of the District Court is reversed, and the case is remanded for entry of judgment and other proceedings not inconsistent with this opinion.

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[2] Apparently the Austin bank usually conveyed bonds directly to customers of the dealers. The Memphis bank, with a few exceptions, consistently observed the formalities of sale and repurchase. Of course such adherence is not dispositive in tax cases when the real question is the economic substance of the transaction.

APPENDIX B

United States Court of Appeals
for the Sixth Circuit

No. 19,409

Union Planters National Bank of Memphis,
Plaintiff-Appellee,

vs.

United States of America,
Defendant-Appellant.

Before: Celebrezze, McCree and Combs, Circuit Judges.

Judgment

Appeal from the United States District Court for the Western District of Tennessee.

This cause came on to be heard on the record from the United States District Court for the Western District of Tennessee and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby reversed and the case remanded for further proceedings consistent with the opinion.

It is further ordered that Defendant-Appellant recover from Plaintiff-Appellee the costs on appeal, as itemized below, and that execution therefor issue out of said District Court.

Entered by order of the Court.

Carl W. Reuss
Clerk

APPENDIX C

In the District Court of the United States
for the Western District of Tennessee
Western Division

Union Planters National Bank of Memphis, Plaintiff, vs. United States of America, Defendant.	No. 67-102 Civil

Opinion

The Plaintiff, Union Planters National Bank of Memphis, brings this suit to recover income taxes paid by it pursuant to assessments of the Commissioner of Internal Revenue for the taxable years 1961, 1962, 1963 and 1964. The controversy concerns the applicability of 26 U. S. C., § 103 which exempts from income taxes the interest on bonds of a state or any political subdivision thereof. Such bonds hereinafter will be called municipal bonds. The Bank did not report as income the interest it received on municipal bonds which were subject to repurchase agreements. These repurchase agreements pertain to transactions between the Bank and security dealers, who transferred the municipal bonds to the Bank for an agreed price plus accrued interest and later reacquired the bonds. During the period that the Bank held the bonds it collected the interest provided for on the coupons attached to the bonds. The Bank contends that it was the owner of the bonds during that period and, therefore, the interest it collected was tax-exempt. The Commis-

sioner contends that the transaction was a loan by the Bank to the dealer whereby the municipal bonds were used as collateral; therefore, the interest received by the Bank was, in fact, interest paid by the dealer on a loan and the interest lost its exempt status.

The determination of this case requires an inquiry into the intent of the parties. The intent of the parties must be determined by the facts and circumstances reflected by the proof in the cause. The significant facts established by the proof are found by the Court to be as follows:

The plaintiff is a National Bank of significant stature in Memphis, Tennessee, and the surrounding area. As of December 31, 1962, the financial statement of the Bank indicated it had resources of $489,625,000.00. In 1938 or 1939 the Bank commenced a practice of entering into repurchase agreements with security dealers in Memphis and the surrounding territory. In these transactions the security dealers had agreed to purchase all, or part, of a bond issue from the state or municipal authority in the regional area. After delivery of the bonds, the dealer took the bonds to the Bank and transferred them to the Bank for money based upon an agreed price which purported to be the cost price. In the usual practice this price was set by the head of the Bond Department of the Bank. The price was less than par value of the bonds and usually the dealer's cost. The transfer was called a sale from the dealer to the Bank and under the terms of the agreement the dealer agreed to repurchase the bonds upon demand by the Bank. The dealer further agreed that the Bank would incur no loss in the transaction. In about 1951, at the suggestion of the Bank Examiners, a written agreement to this effect was adopted and used in most of such subsequent transactions. This written agreement was in use for the years involved in this suit. In some cases no written agreement was executed for

transactions of this character, but the bonds were transferred subject to the same terms as those of the written agreement.

Although the written agreement did not so provide, it was the intent and practice that the bonds be re-acquired by the dealer upon the dealer's request and payment of the value of the bonds. The length of time that the Bank usually held the bonds varied. In most instances the dealer re-acquired the bonds in less than six months. At the time of the transfer of the bonds by the dealer to the Bank, in addition to the agreed purchase price of the bonds, the dealer received accrued interest calculated from the last date that interest was paid by the issuing authority. If the coupons providing for the payment of interest became due while the Bank held the bonds, the Bank invariably clipped the coupons and collected the interest from the issuing authority. Upon the re-acquisition of the bonds by the dealer the Bank collected accrued interest to the date of re-acquisition. The repurchase price was based upon the amount originally paid to the dealer and the Bank made no additional charges nor received any compensation other than the coupon interest.

In some instances the dealer did re-acquire in several transactions less than all of the bonds that the dealer had transferred to the Bank originally. On some of those partial re-acquisition transactions the dealer did not receive the full prorata portion of the original price of the bonds. The amount received was determined by the date when certain bonds within the issue became due, which is a determinative factor in prices of bonds within the same issue.

The record also reflects that on some occasions the Bank required the dealer to pay additional monies while

the Bank held bonds acquired from that dealer. This was considered by the Bank to be an adjustment of the original purchase price and necessary to protect the Bank with regard to that portion of the agreement whereby the dealer agreed that the Bank would not incur any loss on the transaction.

In some instances the Bank, on instructions from the dealer, delivered some of the bonds to customers of the dealer in lieu of transferring the bonds back to the dealer. In those instances, the Bank settled with the dealer upon the price paid to the dealer and the dealer realized as profit the amount of the excess charged to the customer.

In 1957, the Comptroller of Currency issued a ruling requiring this Bank and others to show repurchase transactions on the books of the Bank as loans. In March 1961 the Comptroller of Currency reversed this ruling. During the period that the Bank was required to indicate that repurchase securities were loans, the Bank complied with the requirements of the Comptroller and reported the transactions in its financial statements as "Loans in Repurchase Agreements on Securities". At all times the Bank's books have reflected these transactions in a manner different from municipal bonds which the Bank held for re-sale to Bank customers or which it held in its own investment account. In some instances the Bank actually purchased bonds that it was "carrying" under repurchase transactions. When this was done the Bank paid the dealer the difference between the repurchase price and the market price and appropriate entries were made transferring the bonds on the books of the Bank to a different category of ownership.

The proof reflects that the dealers who had transferred securities to the Bank in transactions of this sort treated the bonds differently during the period the Bank actually

held the bonds. Some dealers treated the bonds as their own assets and showed a corresponding liability to the Bank on their financial statements. Other dealers reflected a contingent liability to the Bank based upon their obligation to repurchase upon demand from the Bank. There is no evidence that the Bank voiced any control over how the dealers handled the transaction. One dealer advertised for sale to its customers those bonds which had been transferred to the Bank. Presumably, this was based upon the understanding and fact that the dealer could re-acquire the bonds upon its request at any time. If a customer of the dealer wished to buy the bonds, the dealer could request the bonds from the Bank and make a profit on the sale to the customer of the dealer.

Negotiations for the repurchase agreement and decision of a discretionary nature pertaining to the agreements were made by the head of the Bond Department of the Bank. These transactions were not presented to the Loan Committee of the Bank which was required by bank practices to approve loans made by the Bank. Although the dealers usually had a line of credit with the Bank and were loan customers for other type transactions, the amounts involved in the repurchase transactions were never sufficient in size to suggest that the repurchase agreements were an effort to circumvent the laws and regulations which limit the amount that a bank might lend any one person or company.

There have been three instances whereby dealers who had transferred bonds to the Bank were unable to repurchase the bonds. In those instances which arose by transfers originating in the years 1945, 1955 and 1956, the Bank subsequently, upon failure of the dealer to re-acquire the bonds after demand, either sold the bonds to third parties or retained the bonds as the Bank's own investment. Profits realized from these transactions were

retained by the Bank and not delivered to the defaulting dealer.

From all of the facts reflecting upon the intent of the parties, the Court finds that the Bank was the owner of the bonds and interest coupons during the period between the transfer by the dealer on to the Bank and the reacquisition of the bonds by the dealer. In this regard, it should be noted that it is significant that coupons which contain the right to collect interest from the issuing authority may have separate ownership. **Edwards v. Bates Co.**, 163 U. S. 269; **Nesbit v. Riverside Independent District**, 144 U. S. 610; **First National Bank of Wichita v. Commissioner**, 57 F. 2d 7 (C. A. 10, 1932). Although some of the facts suggested loan transactions with regard to the bonds, the facts of the instant case clearly establish that the Bank exercised all elements of control and collection over the interest coupons while it held the bonds.

In addition to the determination of the intent of the parties the purpose of the transactions should be considered. The tax-exempt status of municipal bonds was established by Congress "to aid in the flotation of government bonds and securities by making them tax-free and therefore more attractive to investors." **Holley v. United States**, 124 F. 2d 909 (C. A. 6, 1942), cert. den. 316 U. S. 685; **American Viscose Corp. v. Commissioner of Internal Revenue**, 56 F. 2d 1033 (C. A. 3, 1932) cert. den. 287 U. S. 615. The proof in this case reflects, and the Court finds, that the Bank and dealers developed the repurchase practice primarily for the purpose of aiding the dealers in the handling of bonds from relatively small issuing authorities. Both the dealers and the issuing authorities were modest in size and therefore were not likely prospects to attract the larger national investment sources. The practice has been a stimulus to progress in

the immediate geographical area served by the Bank and the dealers.

The proof also establishes that there were indirect benefits to the Bank from these repurchase transactions. They constituted short term ventures, which are necessary for the operation of a well run bank. Good will and business of the security dealers is promoted by permitting the dealers to purchase from the issuing authority and then reselling to the Bank in preference to the Bank being the purchaser direct from the issuing authority and then undertaking to sell the bonds to investors. Furthermore, the co-operative role of the Bank in the issuing authority dealer efforts to float the bond issue stimulates the naming of the bank as trustee under the bond issue or the paying agency as well as increasing the deposits of the bank.

The Bank cites and relies on **Bank of California v. Commissioner of Internal Revenue**, 30 B. T. A. 556, affirmed in **Commissioner v. Bank of California**, 80 F. 2d 389 (C. A. 9, 1935). In that case a similar repurchase agreement was considered and the interest received by the Bank was found to retain its exempt status. This Court believes that the facts of the instant case are sufficiently similar to make that case persuasive authority in the determination of the issues in the instant case. The Commissioner in the instant case relies upon **First National Bank of Wichita v. Commissioner**, *supra*, wherein the Court of Appeals for the Tenth Circuit affirmed a holding by the Board of Tax Appeals that the repurchase transaction in that case was, in fact, a loan and that the dealer continued to own the interest coupons. This Court is of the opinion that the facts of the instant case are clearly distinguishable from the Wichita Bank case. In the Wichita Bank case the Bank charged the dealer interest

on a monthly basis and when the coupons became due the Bank delivered the interest coupons to the dealer. Furthermore, the interest charged to the dealer was not in all instances the same as the interest provided for on the bonds. In the Wichita Bank case the dealer substituted bonds during the course of the transaction. In the instant case no substitution was made and the bonds transferred by the dealer and re-acquired were in all instances identical.

For the reasons set forth above, the Court is of the opinion that the Bank was entitled to treat the interest received by it from municipal bonds as tax-exempt and therefore the Bank is entitled to a judgment for recovery of the tax heretofore assessed by the Commissioner.

This 24th day of October, 1968.

Robert M. McRae, Jr.
United States District Judge

A true copy.

Attest:

W. Lloyd Johnson, Clerk
By H. W. Daniels, D. C.

APPENDIX D

In the District Court of the United States
For the Western District of Tennessee
Western Division

Union Planters National Bank of Memphis,

Plaintiff,

vs.

United States of America,

Defendant.

No. 67-102 Civil

Judgment

This cause came on to be heard by the Court, sitting without a jury, upon the complaint filed by Union Planters National Bank of Memphis seeking a refund of moneys paid by it to the defendant, United States of America, by way of income taxes pursuant to assessment by the Commissioner of Internal Revenue of additional income taxes allegedly owed by the plaintiff for the calendar years of 1961, 1962, 1963 and 1964 by reason of the failure of plaintiff to report as taxable income certain interest received by it during the named taxable calendar years, which interest was paid on bonds issued by state and municipal authorities and was claimed by plaintiff as tax-free income under the provisions of 26 U. S. C. 103, the answer of the defendant, the written stipulation of facts entered into by the parties and filed in the cause, the interrogatories filed by the defendant on January 3, 1968 and the answers thereto filed by the plaintiff on January 23, 1968, the evidence of the witnesses offered by the parties in open Court, the entire record in the cause and the written briefs submitted by counsel for the parties, from all of

which it appears to the Court, for the reasons stated in its written opinion heretofore filed in the cause on October 24, 1968, which written opinion contains the Court's findings of fact and conclusions of law, that the plaintiff is entitled to recover from the defendant the additional taxes and interest paid by it pursuant to said assessments and sought to be recovered in this cause, which additional taxes and interest the Court finds to have been paid by plaintiff to the defendant on April 24, 1967 in the amount of Six Hundred and Forty-Seven Five Hundred and Forty-two & 55/100 ($647,542.55) Dollars.

It is accordingly Ordered that plaintiff, Union Planters National Bank of Memphis, do have and recover of and from the defendant, United States of America, the sum of Six Hundred and Forty-Seven Thousand Five Hundred and Forty-Two & 55/100 ($647,542.55) Dollars together with interest thereon at the rate of 6% per annum from April 24, 1967 until paid.

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United States District Judge

Approved

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Attorney for Plaintiff

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Attorney for Defendant

APPENDIX E.

Bank of California's Repurchase Agreement

"REPURCHASE AGREEMENT

"THE BANK OF CALIFORNIA, N. A., San Francisco, California, a National Banking Association, hereinafter termed 'Seller', agrees to sell, and R. H. MOULTON & COMPANY, hereinafter termed 'Buyer', agrees to buy the following bonds, namely:

"$7,000 City of Hartford Municipal Improvement 5% Bonds.

"Numbers and denominations as follows:

$2,000	Aug. 1, 1958	Nos. 173 74
4,000	Aug. 1, 1961	Nos. 186 89
1,000	Aug. 1, 1963	Nos. 199

"The purchase price of each bond is as follows: (Plus accrued interest)

August 1, 1958 maturity at 95
August 1, 1961 maturity at 95
August 1, 1963 maturity at 95

"payable in United States gold coin of the present standard of weight and fineness, which sum Buyer hereby agrees to pay on or before ninety days from date hereof. Maturing coupons to be the property of THE BANK OF CALIFORNIA, N. A.

"And THE BANK OF CALIFORNIA, N. A. hereby agrees on tender of said purchase price of such bonds and interest as aforesaid to deliver to R. H. MOULTON & COMPANY or its nominee, the bonds as above, at any time hereafter, prior to any default on the part of the Buyer.

"It is further understood between the two parties hereto that partial sales and deliveries may be made at the rates stated above.

"In the event of any failure on the part of the Buyer to accept and pay for any one or more of said bonds at the time the same is tendered, the Seller shall be released from all obligation in law or equity hereunder and may sell all bonds remaining in its hands without notice and for the best price obtainable, charging the loss, if any, to the account of the Buyer.

"Executed in duplicate this 11th day of July, 1929.

"R. H. Moulton & Company
"(Signed) by Elmer Booth
The Bank of California, N. A.
Stuart F. Smith
Vice-President"

APPENDIX F

Petitioner's Repurchase Agreement

REPURCHASE AGREEMENT

"The undersigned is this day selling to Union Planters National Bank of Memphis the bonds listed on Exhibit 'A' attached hereto, and as a condition of said sale and in order to induce Union Planters National Bank of Memphis to purchase said bonds from the undersigned, the undersigned now agrees that on demand made by Union Planters National Bank of Memphis from time to time, it will repurchase from Union Planters National Bank of Memphis any or all of the bonds listed on said Exhibit 'A' for an amount which will be sufficient to prevent Union Planters National Bank of Memphis from suffering or sustaining any loss on the resale of such bonds, and the undersigned hereby fully guarantees and agrees to indemnify Union Planters National Bank of Memphis against any and all loss sustained on or as the result of the resale to the undersigned of said bonds or any of them.

"This .... day of ....., 19....

....."